BLIND SPOTS & ETHICAL DILEMMAS

In light of the corporate scandals, privacy invasions, compromised ethics and governance lapses; what should we be doing differently?

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Overview

ETHICS

01 Ethics as per the IPPF standards
02 Attributes of ethical internal auditors
03 Ethical Culture - Responsibilities
04 Blind spots & Ethical Dilemmas
05 Audit Considerations
1. ETHICS

AS PER THE IPPF STANDARDS
Organizational culture

Determined by the interaction of systems, norms and values, all of which influence behavior.
Ethical culture

A strong ethical culture is created through a robust ethics program that sets expectations for acceptable behaviors in conducting business.
Ethical Values

Personal
Shaped by religion, upbringing and personal experiences

Organizational
Defined to promote consistent integrity

CLASHES??
In executing their responsibilities, Internal Auditors are faced with conflicting situations where they must:

1. Make an ethical decision
2. Make difficult/uncomfortable inquiries
3. Face sensitive issues/political dilemmas that appear to be in violation of the corporate code-of-conduct.
IIA Code of Ethics

Minimum requirements for conduct and behavioral expectations
IIA Code of Ethics

It is intended to guide the ethical conduct of internal auditors

Principles

Rules of Conduct
IIA Code of Ethics

1. **Competency**
   - Knowledge, skills & Experience

2. **Objectivity**
   - Balanced assessment

3. **Confidentiality**
   - Respect information value

4. **Integrity**
   - Establish trust and reliance
Principle 1

Competency

Internal auditors apply the knowledge, skills, and experience needed in the performance of internal audit services.
Principle 2

Objectivity

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.
Principle 3

Confidentiality

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.
Principle 4

Integrity

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.
“If you have *integrity* nothing else matters,
And if you do not have *integrity*, nothing else matters”.

- Harvey Mackey
Exercise 1

• Apply the code of ethics to decisions
Example: Apply the code of ethics to decisions

Through an audit of the credit department, CAE became aware of a material misstatement of the year-end accounts receivable balance. The external auditor has completed the audit without detecting the misstatement. What would the CAE do in this situation?

a. Inform the external auditor of the misstatement Correct – Rule of conduct 2.3 states: “Internal auditors shall disclose all material facts known to them that, if not disclosed, may distort the reporting of the activities under review.

b. Report the misstatement to management when the external auditor presents a report

c. Exclude the misstatement from the internal audit report because the external auditor is responsible for expressing an opinion on the financial statements

d. Perform additional audit work on accounts receivable balance to benefit the external auditor

Source: Powers Resources Corporation CIA Exam Review
Example: Apply the code of ethics to decisions

A CIA working as the director of purchasing signs a contract to procure a large order from the supplier with the best price, quality and performance. Shortly after signing the contract, the supplier presents the CIA with a gift of significant monetary value. Which of the following statements regarding the acceptance of the gift is correct?

a. Acceptance of the gift would be prohibited only if it were non-customary

b. Acceptance of the gift would violate the IIA Code of Ethics and would be prohibited for a CIA – Correct: As long as an individual is a CIA, he should be guided by the IIA Code of Ethics in addition to the organization’s Code of Conduct. Rule 2.2 of the IIA Code of Ethics would prelude such a gift because it would be presumed to have influenced the individual’s decision.

c. Since the CIA is not acting as an internal auditor, acceptance of the gift would be governed only by the organization’s code of conduct

d. Since the contract was signed before the gift was offered, acceptance of the gift would not violate either IIA Code of Ethics or the org code of conduct

Source: Powers Resources Corporation CIA Exam Review
Example: Apply the code of ethics to decisions

Which of the following situations would most likely be considered violation of Code of Ethics?

a. As Director of Internal auditing you have become perplexed as to how to resolve a particular disagreement between you and the auditee management regarding the finding and recommendation in a very sensitive audit area. Unsure as to what to do, you discuss the detail of the finding and your proposed recommendation with a fellow audit director you know from your work in The Institute of Internal Auditors, local chapter. Correct – The Code of Ethics requires Confidentiality

b. After researching and developing the proposed yearly audit plan, your company audit charter requires that as director you present the plan to the audit committee for approval and suggestions

c. Your audit manager has just removed your most significant finding and recommendation from your audit report. Being the in-charge auditor, you have voiced your opposition to and have explained that you know the reported condition exists. Although you agree that, technically, the audit lacks sufficient evidence to support the finding, management cannot explain the condition and your audit finding is the only reasonable conclusion.

d. Because your department lacks skills and knowledge in a specialty area, you audit director has engages the services of an expert consultant. As audit manager you have been asked to review the expert’s approach to the assignment. You are knowledgeable regarding the area under review but are hesitant to accept the assignment because you lack the expertise to judge the validity of the expert’s conclusion.
2. ATTRIBUTES OF ETHICAL INTERNAL AUDITORS
Modern internal auditors must have, in addition to the technical knowledge and insight, the state of mind and executive presence necessary to operate in today’s complex business world.
Working to ensure things go right before they can go wrong

It takes courage to do the right thing

It all sums up, People will turn to IA as role models

Build a history of ethical behavior, so people can trust.

7 Attributes of Ethical Internal Auditors, Richard Chambers

Treating others with respect and compassion

Accountable for the actions & resulting perceptions
3. ETHICAL CULTURE
(Responsibilities)
Everyone should be an ethics advocate...

**Board of Directors**
Build Governance Framework
Oversees the ethical climate, needs assurance

**Senior Management**
Set the Tone at the top
Foster Ethical Culture & monitor results

**Operations Management**
Promote Ethical Behavior
Exemplify and evaluate sub-culture in their area

**Employees**
Share Responsibility
Instill and promote integrity & accountability

*Internal audit* must be viewed as a role model and an advocate of strong ethics.
Role of Internal Audit

Have **adequate business acumen** to identify unethical behaviors, Raise red flags if any unethical practices suspected **AND** Exercise due diligence by following-up

Be trusted, **possess high level of integrity**, and possess skills to be effective advocate of ethical conduct

Have the **competence to influence** the leaders and employees’ behavior to comply with the ethical responsibilities

Perform independent and **objective assessments** to provide assurance that the governance structure is properly designed and operating effectively

Proactive and act as a catalyst for change
Questions the Board should ask about an Ethics and Compliance program in their organization
Exercise 2

– Provide examples of ethical violations and reporting channels
– What is the impact of unethical behaviors?
Exercise 2 - Ethical violations reporting channels

• Hotline for reporting integrity/business ethics issues
• Manager/supervisor
• Incident Reporting System
• Human Resources Department
• Compliance/Legal/Internal Audit Department

Reporting channels should be accessible to all employees at all times (in writing and/or verbally). Employees must be informed and trained on the use of those reporting channels.
Exercise 2 - Examples of Ethical Violations

- Corruption: bribing, favoritism...
- Fraud and theft or waste of resources
- Conflict of interest (gifts, sideline activities...)
- Abuse of power or authority
- Falsifying documents
- Misuse and manipulation of information
- Indecent treatment of colleagues/customers
- Undue sick leave
- Misconduct in private time
Exercise 2 - Impact of unethical behaviors

- Legal ramifications
- Financial damage
- Company credibility/reputation damage
- High level of risk, stress and conflict
- Lower productivity
- Stakeholders trust

“Trust takes years to build, seconds to break, and forever to repair.”
- SearchQuotes.com
3. ETHICAL CULTURE
(Contributing Factors)
Ethical Lapses

Ethical lapses and Fraud schemes continue to evolve in Complexity ... with serious consequences...

- Financial
- Reputation
- Socio-Political
Sources of ethical lapses = Opportunity + Judgement
(judgment influenced by greed, ambition, financial pressure...)

Employees might be reluctant to report ethical lapses due to:
• No concrete corrective measure by management
• Lack of anonymity and fear of retaliation
• No clear reporting channels
Important steps to prevent Ethical Lapses

Build a **culture of integrity from the top down** and lead by example

**Establish a code of conduct and a system of checks and balances** to minimize opportunities for unethical behavior

**Assess the employees’ understanding and adherence** to the code of conduct

**Foster empowerment & interaction across the hierarchy to raise concerns and express grievances**
Important steps to prevent Ethical Lapses

Support **effective whistleblowing and grievance mechanisms** and build trust in the integrity of the reporting system.

Ensure **transparency, open communication and clear accountability**, implement **effective disciplinary measures**.

Ensure **company’s metrics don’t create pressure** that influence employees to cut corners.
4. BLIND SPOTS AND ETHICAL DILEMMAS

Standard 1100 states: “Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. …”
Ethical Dilemmas

“Grey area” situations with no pre-defined answers. Employees have to “invent” the solution.

Difficulty in deciding is not choosing between the right or wrong, but rather from being forced to choose from a “not-so-perfect” set of options. Choosing the “best-of-the-worst”
Ethical dilemmas

1. **Understand**: what facts are relevant in that situation?
2. **Analyze**: what laws / code of conduct are applicable?
3. **Resolve**: what is the possible solution?
   - Seek guidance as you deliberate, explore important considerations and reach a possible solution.
   - what happens when that solution is implemented?
   - The right thing is not necessarily the easy thing (pressure?)
Ethical dilemmas

Making a good ethical decision in the audit engagements require the auditors to:

• Understand ethical values
• Be able to fully understand a situation from different perspectives
• Have the willingness and desire to do the right thing
Sample – Ethical Checklist

Ethical Checklist of the Chartered Institute of Management Accountants (CIMA)
Example: Apply the code of ethics to decisions

An internal auditor who encounters an ethical dilemma not explicitly addressed by the IIA Code of Ethics must always:

a. Seek counsel from an independent attorney to determine the personal consequences of potential actions
b. Take action consistent with the principles of the IIA Code of Ethics
c. Seek the counsel of the audit committee before deciding on an action
d. Act consistently with the organization’s code of ethics even if such action would not be consistent with the IIA Code of Ethics

Source: Powers Resources Corporation CIA Exam Review
Example: Apply the code of ethics to decisions

An internal auditor who encounters an ethical dilemma not explicitly addressed by the IIA Code of Ethics must always:

a. Seek counsel from an independent attorney to determine the personal consequences of potential actions

b. Take action consistent with the principles of the IIA Code of Ethics – Correct: This is consistent with the concepts embodied in the IIA Code of Ethics

c. Seek the counsel of the audit committee before deciding on an action

d. Act consistently with the organization’s code of ethics even if such action would not be consistent with the IIA Code of Ethics

Source: Powers Resources Corporation CIA Exam Review
Motivated Blindness

The closer you are to a person

More likely to

Overlook their misbehavior

More likely to

Deny that it is a misbehavior

More likely to

Come up with justifications for their misbehavior
“Motivated blindness is when you don’t recognize facts that are sitting in front of you because they would be inconvenient for you to recognize”.

- Warren Buffet
Blind Spots

“Motivated Blindness” is unconscious and common; it contributed to:

- Failure of major accounting firms to see the corruption in the books of the firms that they audit.
- Auditors who want to sell consulting services to their clients, and who may even consider job offers from those same clients, be motivated to overlook the corruption.
Blind Spots

• Best practice policies, procedures and systems alone are not enough
• Sometimes good people will do bad things when under pressure; and then rationalize their misconduct as acceptable.
• Red flags/s signals often exist—finding them and joining the dots require broad and inquisitive thinking.
RED FLAGS INDICATORS

- BUSINESS
- EMPLOYEE
- STRUCTURAL
- CULTURAL
Examples of EMPLOYEE Behavior Indicators

- Rarely takes holidays
- Refuses or does not seek promotion
- Obsessive secrecy
- Bullies or intimidates colleagues
- Tendency to bend the rules / cut corners
- Lifestyle and income mismatch
- Autocratic management style / decision making
- Evasive/overly complicated answers to routine queries
- Certain mundane tasks are retained instead of delegating
- Close relationship with supplier or customer guarded and dealt with exclusively by one employee

Source: Study by KPMG on Ethics and Integrity, Blind spots & Red flags
Examples of CULTURAL Indicators

• Use of a favored few suppliers
• Culture of favoritism
• Dominant management attitude of “results at all costs”
• High employee attrition, low staff morale
• Minor but regular failures to follow procedures or policies
• Passive and unquestioning staff who may be turning a blind eye to irregularities

Source: Study by KPMG on Ethics and Integrity, Blind spots & Red flags
Examples of STRUCTURAL Indicators

- Lack of segregation of duties
- Frequent change of auditors
- Transactions or structures created with no clear purpose
- Large number of purchases just below approval limits
- Lack of clear reporting lines or areas of responsibility
- Unnecessarily large numbers of adjusting entries
- Discovery of undisclosed private businesses controlled by employees or directors

Source: Study by KPMG on Ethics and Integrity, Blind spots & Red flags
Examples of BUSINESS Indicators

• Results exceed market trend
• Aggressive forecasts
• Regular profit warnings
• Liquidity problems
• Key documentation missing
• Increasing number of customer complaints
• Results always at or just above budget

Source: Study by KPMG on Ethics and Integrity, Blind spots & Red flags
5. AUDIT CONSIDERATIONS

2110.A1 – The internal audit activity must evaluate the design, implementation, and effectiveness of the organization’s ethics-related objectives, programs, and activities.
Audit considerations

1. An *entity-wide survey* can provide a reasonably accurate measure by identifying gaps between the desired and actual ethical climate, leading to action plans to bridge those gaps.

2. *Review of ethics-related policies and activities* assessing the methods used to measure their effectiveness.

3. *Audit of specific ethics-related functions* and assessing the effectiveness of the key controls that serve to mitigate risks that impact ethics-related programs.

4. Maturity of the ethical culture evolves. It is *more useful and less controversial to use a maturity model* to assess the maturity of the various elements of the ethical climate.
Exercise 3 – Define the Maturity Levels of:

a. How does the organization perceive management’s commitment to compliance?

b. How effectively does the Code outline management’s expectations regarding ethical conduct?
Exercise 3a – Culture and Consistency (How does the organization perceive management’s commitment to compliance?)

1. INITIAL
   - Organization seem indifferent to compliance.
   - Non-compliance issues are typically learned from complaints versus monitoring.

2. REPEATABLE
   - Compliance is perceived as important.
   - While ethical conduct seems to be considered, it is not embedded in the JDs.
   - Timely reporting of non-compliance but not before they become non-compliant.

3. DEFINED
   - There are perceptions that senior management takes compliance seriously.
   - Comprehensive program is developed.
   - JDs include expectations for ethical conduct.
   - Many employees raise compliance questions before they become non-compliant.

4. MATURE
   - Compliance and ethics are topics at organization and department-level meetings, ensuring a consistent message.
   - Disciplinary decisions are appropriate and consistent.
   - Employees feel empowered to raise questions about compliance matters.

5. WORLD-CLASS
   - Periodic surveys or focus groups are conducted to assess the perception of compliance culture and make adjustments if needed.
   - Periodic input is solicited from employees to help improve the program.
   - People are recognized for demonstrating ethical conduct.
   - Employees make recommendations for improving the compliance program.
Exercise 3b – How effectively does the Code outline management’s expectations regarding ethical conduct?

1. INITIAL
   Code of Conduct not formally documented

2. REPEATABLE
   Code of Conduct established but may not be comprehensive or current

3. DEFINED
   Code of Conduct established, approved by the Board, reviewed periodically and employees sign off compliance with it annually

4. MATURE
   Code of Conduct is reviewed annually and updated as necessary. All Employees complete annual questionnaires asking probing questions about compliance with the code of conduct

5. WORLD-CLASS
   Specific compliance policies are in place to support and provide additional guidance on key components of the Code of Conduct.
   Focus groups and surveys are conducted periodically to assess employee understanding, perception and compliance
KEY TAKEAWAYS

Getting the right ethics and integrity embedded within a business is a complex process
Summary - Main Contributing Factors

1. Culture of Integrity
2. Strong tone-at-the-top
3. Code of Conduct
4. Improved Communication and training
5. Effective whistleblowing process
6. Sound corporate governance
7. Ethical metrics
Thank You!

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